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C O N F I D E N T I A L SECTION 01 OF 02 KUWAIT 001123

SIPDIS

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TAGS: EFIN ECON EINV KU
SUBJECT: GULF BANK: BETTING AGAINST THE DOLLAR... AND
LOSING BIG TIME

REF: KUWAIT 1089

Classified By: Econcouns Oliver John for reasons 1.4 (b) and (d)

¶1. (SBU) Summary: The Kuwaiti financial sector continues to feel the impact of Gulf Bank's trading losses (reftel). Speculation abounds as to the extent of the losses, the identity of the "client" who defaulted on derivatives contracts, and the role of the Central Bank of Kuwait in stabilizing Gulf Bank. Compounding the intrigue is the boardroom maneuvering involving the bank's largest shareholders, as well as the Amir's purported displeasure with Kuwaiti banks' owners and managers. Meanwhile, the National Bank of Kuwait (NBK), Kuwait's largest bank, is actively mulling a takeover of Gulf Bank. End Summary.

BILLION DOLLAR LOSS

¶2. (C) Bailout negotiations are ongoing between Gulf Bank's management and shareholders and the Central Bank regarding the massive trading losses incurred by a Gulf Bank "client" in late October (as a result of bad euro-dollar derivatives contracts). According to a senior Gulf Bank executive, five bank clients had undertaken a series of 14 to 16 derivatives transactions beginning in 2006. It was not clear whether these transactions had been properly approved. One client (allegedly Pearl of Kuwait Real Estate Co., whose chief, Mahdi Haider, is also a Gulf Bank board member) was responsible for 70 percent of the total trading losses. Haider,s company had borrowed euros to renovate a German hotel and wanted to convert to dollar liabilities. The company restructured the derivatives contract to deal with increased dollar-euro volatility, which increased its contingent liabilities ten-fold, but failed to hedge against October,s sharp fall in the euro. When the counterparty demanded repayment, the total loss came to one billion dollars (or just over half of Gulf Bank's total regulatory capital). The senior executive added that when the bank structured the original contract in 2006, its employees believed that the bank was merely acting as a broker between the client and a third party. Unfortunately, the derivatives were structured as two contracts: between the bank and its client and between the bank and the counterparty. Haider's company was unable to pay the bank and the bank was forced to pay the counterparty. Once the loss was discovered, Gulf Bank managers notified the Central Bank. (Note: Diwaniya rumors and others within the bank had initially suggested that the client was an investment vehicle controlled by the Alghanim family. The largest shareholder of Gulf Bank is Alghanim Industries, controlled by Kutayba and his eldest son, Omar. Kutayba was appointed Chairman of the bank's board two days after the losses were announced. A number of industrial conglomerates hold large positions in Kuwaiti banks -- such strategic investments allow these conglomerates to leverage banks' balance sheets, lending facilities and trading desks for their own purposes. End note).

¶3. (C) Gulf Bank and certain of its shareholders are actively working with the international arbitration department of the blue chip U.S. law firm Shearman & Sterling LLP, which dispatched lawyers to Kuwait from its Paris office on October ¶31. One of these lawyers indicated to econoff that negotiations are ongoing between Gulf Bank's shareholders and the Central Bank to agree on the terms of a rescue package that would allow Gulf Bank to meet its liabilities. One media report on November 11 suggested that Shearman & Sterling was helping Gulf Bank to prepare legal action against Pearl of Kuwait Real Estate Co., essentially pitting the bank's board members against one another. Two other sources in Gulf Bank's senior management stated that the Kuwait Investment Authority (KIA) was considering a large infusion of capital into the bank. (Note: the KIA has reportedly invested approximately $1 billion in the Kuwait Stock Exchange (KSE) in the past two months and is actively weighing investments in Kuwaiti investment firms. End note).

¶4. (C) Trading in Gulf Bank,s shares on the KSE continues to be suspended. According to a senior bank executive, were trading of the bank's shares to recommence prior to the rescue plan's completion, then the bank's stock might fall sharply and drag down the broader banking sector. Fawzi Al-Sultan, a member of the ad hoc committee established by the Council of Ministers on October 26 to deal with the effects of the global financial crisis, noted that the relative slowness of the Central Bank's rescue plan was due in part to constitutional limitations on the GOK's ability to loan public monies to private entities: Article 136 of

Kuwait's Constitution mandates that a law be promulgated by the legislature to effect such loans. (Note: Kuwait's press reported on November 4 that the GoK has referred all of the bank,s board members to the public prosecutors, based on a KIA accusation of misuse of public funds. End note).

¶5. (SBU) Reportedly, the Amir of Kuwait, Shaykh Sabah Al-Sabah, summoned bank chiefs and owners to express his displeasure regarding the circumstances of the Gulf Bank trading losses and the propensity of major shareholders to treat banks like their personal wallets.

CONSOLIDATION SPECULATION

¶6. (C) Local media reports and contacts in NBK's management indicate that NBK is actively considering acquiring or taking a sizeable stake in Gulf Bank, with plans to convert Gulf Bank into an Islamic bank. Demand for Islamic banking services is mounting in Kuwait and other GCC nations. According to one Gulf Bank official, NBK would gain access to the bank's 300,000 customer base, but would need the GoK to deal with the non-performing assets. The GoK would benefit by potentially reducing the funds it would need to commit to recapitalize the bank. (Note: Kuwait International Bank converted into an Islamic bank earlier this year, and the Bank of Kuwait and the Middle East (BMKE), another leading Kuwaiti banking institution, will convert into an Islamic bank in early 2009. It appears that the global financial crisis might accelerate the trend towards Islamic banking in Kuwait. Post will report on this shortly. End note).

FALLOUT IN THE INVESTMENT SECTOR

¶7. (C) The Gulf Bank crisis, combined with the precipitous declines on the KSE in the past three months, has prompted concern in the local press about the overall health of the banking sector. Most observers argue that the Gulf Bank crisis is a unique case and that Kuwait's other major banks

are in relatively good shape. However, some are voicing concern about the soundness of Kuwait's many investment companies (approximately 120, of which approximately 85 are listed on the KSE). Reportedly, many of these firms are highly leveraged and have reaped major losses in recent stock market declines around the world. One investment fund chief, Ahmad Al-Hamad (Managing Director of the $400 million Kuwait China Investment Company and son of a former Minister of Finance) told econoff that as many as 80% of Kuwait's investment companies are "under water" and face insolvency problems related to short-term liabilities. On November 5, the ad hoc committee (set up by the Council of Ministers to deal with the effects of the global financial crisis) announced that a mechanism had been agreed upon whereby Kuwaiti banks would provide liquidity to investment companies, the Central Bank would ease sectoral lending constraints and the KIA would provide long-term deposits to banks. Committee member Fawzi Al-Sultan was more sanguine about the health of Kuwaiti investment companies, claiming that most were not in fact highly leveraged, noting that three of the larger investment firms had indicated to the ad hoc committee that they did not require assistance.

¶8. (C) Comment: Based on the information we have, the troubles afflicting Gulf Bank are not emblematic of wider, systemic problems in the Kuwaiti banking sector. Gulf Bank's woes are likely more serious than originally reported in the press, and the bank's survival is contingent upon a major rescue package involving the Central Bank, key shareholders and possibly the KIA. Post believes that the GOK will not permit Gulf Bank to collapse, though it may encourage or compel a merger. End comment.

JONES